

STATE ATTORNEYS GENERAL
A Communication From the Chief Legal Officers
Of the Following States

Arizona * Connecticut * Illinois * Iowa * Maryland * Massachusetts * Minnesota * Missouri
New Hampshire * North Carolina * Ohio * Rhode Island * Tennessee * Vermont * West Virginia

December 23, 2009
Via Electronic Mail

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Comments to Advanced Notice of Proposed Rulemaking, R-1366
Regulation Z – Truth In Lending – Closed-End Mortgages

Dear Secretary Johnson,

As the primary state law enforcement officials charged with protecting consumers from unfair and deceptive acts or practices in mortgage lending, we are writing in response to the Federal Reserve's proposed amendments to Reg. Z, as set forth in the Advanced Notice of Proposed Rulemaking of August 26, 2009. These comments are submitted on behalf of the Attorneys General of Arizona, Connecticut, Iowa, Illinois, Maryland, Massachusetts, Minnesota, Missouri, New Hampshire, North Carolina, Ohio, Rhode Island, Tennessee, West Virginia, and Vermont.

Our comments focus on the Board's proposal to prohibit originator compensation based on the terms and conditions of the loan. We believe that this proposed change, more than the proposed new disclosures, will provide consumers with significant protections against the unfair and deceptive acts and practices that led to the collapse of the mortgage market and resulting foreclosure crisis. Although we generally view the new disclosures as marked improvements over what is currently mandated, we are also aware that abuses in the mortgage market grew rampant in the last decade despite an abundance of disclosure requirements on the books. We urge the Board to continue working with Congress, and with federal and state regulatory agencies, to enact reforms that prohibit and prevent the recurrence of unfair and deceptive acts and practices in mortgage lending.

I. Prohibiting Originator Compensation Based on Characteristics of the Loan

The state Attorneys General were among the first to warn and take action against unfair and deceptive acts and practices in the residential mortgage lending markets, both prime and subprime. Together, the states brought multi-state consumer fraud actions resulting in large-dollar settlements with major lenders such as Famco, Household, Ameriquest and Countrywide. These actions also resulted in injunctive relief that prohibited the lenders from engaging in unfair and deceptive acts and practices going forward and required them to implement reforms introducing more fairness and increased transparency to their sales practices.

Individually, the states have also brought actions against numerous lenders and brokers, both large and small. For example, Ohio successfully sued New Century, and Massachusetts sued Fremont Investment & Loan and Option One Mortgage Corp., and reached a settlement with Fremont after the state's highest court confirmed the fundamental aspects of the Attorney General's case—that a lender's failure to reasonably assess a borrower's ability to repay a loan and the use of loan features that predictably lead to foreclosure constitute unfair and deceptive practices. Separately, in November of 2006, New York settled claims of lending discrimination against Countrywide and, as recently as this year, Illinois has brought a fair lending lawsuit against Wells Fargo.

Through these enforcement actions, and the extensive investigations that led up to them, the state Attorneys General have reviewed significant numbers of loans containing yield spread premiums (YSPs)¹ and have analyzed similar sales incentives structures used by a variety of lenders across the mortgage lending market. States also have interviewed thousands of borrowers about their experiences with loan products containing these features. In our informed view, YSPs and similar sales incentives almost always work to the disadvantage of consumers. Moreover, by driving sales of tainted loan products, these forms of originator compensation also work to the detriment of downstream investors, who purchase the loans through the securitization process with little knowledge of their origins.

A. Consumers Are Significantly Harmed by Yield Spread Premiums

The states strongly support the Board's proposal to ban payments made to mortgage brokers and others acting as originators based on the characteristics of the loan. We particularly support the proposed ban on YSPs. In the consumer market, YSPs create a fundamental conflict of interest between retail mortgage brokers and consumers. YSPs commonly defeat the consumer's reasonable expectation of an above-board relationship

¹ A yield spread premium is the present dollar value of the difference between the lowest interest rate a wholesale lender would have accepted on a particular transaction and the interest rate a mortgage broker actually obtained for the lender. Some or all of this dollar value is usually paid to the mortgage broker by the creditor as a form of compensation, though it may also be applied to other closing costs.

with the broker, a relationship that the consumer presumes to include good faith and fair dealing on the part of the broker. YSPs create an anti-competitive barrier that hinders a consumer's access to less expensive and safer loan products that are otherwise readily available on the market. In transactions containing YSPs, originators are incentivized to select risk-prone and costly loan-product features and, conversely, to steer customers away from lower-priced alternatives containing more cost-efficient terms and conditions.

Similarly, when lenders maintain their own retail operations, perverse incentives are created by in-house sales commission structures that base awards on the amount of "overages" an originator can impose on a transaction.² Overages encourage retail loan officers, who operate within vertically integrated product-origination environments, to ignore the better-suited loans that are available from their own lender's product inventory, in favor of loans with terms and conditions that only serve to enhance revenue. Overages and similar incentives encourage originators to "up sell" consumers into more expensive products that often prove to be beyond the consumer's repayment capacity.

Both incentives, YSPs and overages, encourage the broker or loan originator to market and recommend loans with terms and conditions that make the loans less affordable and more susceptible to default. Often, when states have interviewed independent retail brokers or in-house loan officers employed by the lenders, these loan originators have told us they were motivated by cash incentives to add expensive, risky and complicated product terms and conditions to the loans that they sold, unbeknownst to consumers. In the financial markets, these incentives increase the likelihood that the end investor, who buys and holds the loan, will not be repaid and will have no alternative other than to foreclose on the loan. In our experience, YSPs and similar sales incentives played a pivotal role in driving sales of the toxic home loans whose high failure rates precipitated the nation's foreclosure crisis, devastated communities, and placed our financial system at risk.

In our work on the front line of the foreclosure crisis, the states have seen many consumers who were steered into loans with exotic characteristics that they did not understand, and which produced disastrous outcomes that they could not anticipate or control. Far too many of these distressed homeowners were placed into mortgage loans with YSPs. Most borrowers, and particularly subprime borrowers, come to the mortgage transaction with little understanding of how the transaction is structured, or of the underlying nature of relationships between the parties. Consumers often believe, and brokers often suggest, that the broker is looking out for the consumer's best interests. In fact, few consumers can imagine any reason to engage and pay for a broker, other than to protect their interests in navigating through the forbidding intricacies of the typical mortgage loan transaction. Unsophisticated borrowers, such as first-time home-buyers or

² An overage occurs when an originator closes a loan with higher points than are required on the price sheet for that loan, or when the originator obtains a premium interest rate for the lender. These higher prices are not based on higher risk or borrower-neutral factors such as market conditions.

the elderly, are particularly vulnerable to being taken advantage of in a vast market fraught with complexity.

For example, states have received numerous complaints from consumers who thought they were getting a 30-year fixed loan but were ultimately placed in a hybrid-ARM. Few consumers, when asked during our investigations, could explain the purpose or effect of the margin on the rate adjustment written into their ARMs. Similarly, states have interviewed many consumers who were completely unaware that they had been sold into loans with prepayment penalties, let alone understood the relationship of prepayment penalties to YSPs. During our investigations, states have been told by loan originators that lenders would routinely require brokers to refund a YSP or overage in the event that the loan did not last until the lender broke even on the cash payment. (A loan might not last until the break-even point, for example, if the borrower refinanced because market rates dropped.) As we also learned, the originator could hedge against having to refund the cash premium by including a prepayment penalty in the loan. In this way, the premium would be recaptured for the lender at the time the borrower tried to leave the loan. The brokers called this practice “closing the back door.”

There may be many other reasons that the terms and conditions were inappropriately varied or inserted in mortgage loan transactions on a wide scale in the run-up to the foreclosure crisis, but there is no doubt that a primary reason was that brokers were incentivized to place consumers into non-traditional loans containing complex features beyond a consumer’s understanding. Moreover, the major sources of those incentives—YSPs and overages—were rarely if ever made transparent. Banning sales-based commissions and premiums paid to originators as incentives to vary a loan’s terms and conditions eliminates much of the danger of broker self-dealing and misplaced consumer trust, while otherwise allowing for brokers and lenders to be sufficiently compensated.

Proscribing compensation based on the characteristics of the loan will reduce foreclosures going forward and ensure a more stable and transparent market. We urge the Board to adopt the proposed rules banning YSPs and all forms of payments made to originators based on a loan’s terms and conditions.

B. Disclosing Yield Spread Premiums is Not Effective

Merely disclosing the existence of a YSP on the HUD-1 or other form does not eliminate the inherent danger of this form of compensation. Most consumers with whom the states have talked did not understand what a YSP was at the time of their mortgage transaction, even when the YSP was disclosed. Many closed their loans without realizing that the broker was going to be paid the premium by the lender. Perhaps worse, many consumers thought that their broker was looking out for their best interests. It would never have occurred to most consumers that their broker was not shopping around for the best loan, and could in fact profit by placing them into a more expensive loan.

The danger that brokers will place consumers into unaffordable loans for their own gain is aggravated by limited competition in the subprime market. Most subprime borrowers do not actively search for a broker. Instead, the vast majority of subprime borrowers the states have interviewed were actively sought out and targeted by the mortgage industry. Consumers are subject to heavy pressure from affinity marketing, telephone calls, and even door-to-door visits by brokers. In an ideal marketplace, consumers would compare different brokers and make an informed choice based on a broker's fee and perceived skill. This ideal, however, is far removed from the actual marketplace that serves subprime borrowers.

C. Other Ways Exist to Compensate Brokers

From the consumer's standpoint, there is no legitimate economic reason for compensation based on the characteristics of a loan. YSPs are often justified by brokers and lenders as a way to allow consumers to pay for the broker's fee by incorporating it directly into the mortgage. This concept makes sense in theory, but bears little relation to the function and purpose of YSPs in the marketplace. A fee based on the characteristics of the loan should be viewed for what it is: a transfer of cash from the lender to the broker resulting in no net gain or even a net loss for the consumer. This form of compensation should be banned, as proposed by the Board. Cash-strapped consumers would still have the option under the rule of paying the broker's fee as part of the loan—by adding the fee directly to the principal balance, for example.

The proposed rule leaves open many additional ways in which brokers can seek compensation. Brokers can still be paid a flat fee by the consumer, and can be paid by the lender based on volume of loans and performance of loans. Importantly, brokers can still be paid fixed hourly fees for the amount of work they actually do. If a loan is particularly complex and takes up more of the broker's time, the broker can be compensated accordingly, as long as the compensation is for his actual time, rather than the characteristics of the loan.

The proposed rules also allow loan originators to be paid based upon the long-term performance of the loan. The states strongly support allowing compensation of this kind, and urge the Board to explore ways to encourage its use. Much of the current foreclosure crisis can be traced to the minimal interest most market participants had in the long-term performance of the loan. Lenders and brokers immediately sold off loans to the next entity down the chain of securitization, and suffered no impact if the loan they originated later defaulted. Compensating originators based on the long-term performance of the loan would require them to keep some skin in the game and to care about more than just obtaining the consumer's signature on the bottom line.

D. Answers to Specific Board Questions

In addition to our general support for the Board's proposed rule, the states offer the following comments to specific questions by the Board:

1) The Rule Should Apply to Both Low and High-Cost Loans

The states recommend that the rule apply to all mortgages, regardless of cost. Although many of the worst problems in the mortgage market occurred in the origination of subprime or high-cost loans, the same underlying defects associated with YSPs apply to prime and alt-A loans as well. For example, many pay-option ARMs (POAs) sold during the housing bubble do not meet the definition of “high cost” loan. And yet POAs are among the worst performing loans in today’s market. An across-the-board application of the proposed rule would remove the industry’s incentive to engineer and mass market exotic, and ultimately toxic, prime or alt-A products in the future.

2) The Rule Should Apply to Principal Balance

The states recommend that the ban on compensation based on loan characteristics be applied to prohibit compensation based on the size of the loan’s principal amount. A key cause of the foreclosure crisis was appraisal inflation. Brokers received greater compensation for originating larger loans, and thus were incentivized to inflate the principal amount of loans to the largest extent possible. States have brought actions against lenders and appraisers for this type of loan-principal inflation and have seen first-hand the negative impacts of inflated property values. Removing a broker’s incentive to originate larger loans would reduce artificially inflated home values, and ultimately lead to fewer foreclosures. Although a larger loan may legitimately take more of a broker’s time than a smaller loan, the proposed rule allows for this eventuality by permitting brokers to be compensated for extra time spent on a transaction, as long as the compensation is based on the actual time invested rather than the amount of the loan.

3) The Rule Should Apply to HELOCs

The states strongly recommend that the proposed rule cover open-end mortgages (HELOCs) as well as closed-end mortgages. HELOCs are susceptible to the same forms of steering pressure and manipulation of terms and conditions that apply to first-lien closed-end mortgage loan transactions, as described above. In addition, HELOCs pose concerns that are unique to their peculiar place as secondary secured transactions and that give rise to a different set of drivers, rewards, motives and abuses in the marketplace.

For instance, in our investigations, the states have observed certain lending practices where, in return for enhanced pay or extra commission, originators were routinely encouraged to split a loan in two. Originators would often do this by pairing a first-lien closed-end mortgage loan with a HELOC in a simultaneous (or nearly-simultaneous) closing transaction. The practice of dividing into two a loan that could otherwise have been originated as one was called “piggybacking.” Often, when originators were compensated on a unit-based quota system, a HELOC was originated to generate more revenue for the originator, even if the HELOC was not in the borrower’s best interests. Consequently, it was commonplace for two loans to be originated when one would otherwise have been more efficient and less expensive for the consumer.

Often the piggybacked loans brought the combined loan-to-value (LTV) ratios up to or above 100 percent of the property's value. Sometimes HELOCs were inappropriately used to circumvent private mortgage insurance requirements and place borrowers in high LTV situations without leaving any credit default protections in place. Many lenders had LTV thresholds or caps on the amount sought to be borrowed. If the amount the consumer sought on the loan exceeded the LTV threshold, the lender required the consumer to purchase private mortgage insurance. To get around this requirement, originators often split the amount sought to be borrowed into a first-lien loan and a second-lien loan. The first-lien loan would be written for an amount less than the cap to avoid the PMI trigger. The remainder of the total amount sought to be borrowed would be applied to a simultaneous-second or piggyback loan, in the form of a HELOC. Because the HELOC was in second-lien position, the interest rate applied to it would generally be more expensive than the rate applied to the loan in first-lien position.

Often, the combined interest rate on both the first-lien loan and the HELOC exceeded the rate that would have applied if the total borrowed had been combined in a single first-lien loan amount, even with the private mortgage insurance premium added. Even when this arrangement in fact produced an initial advantage for the consumer, any savings benefit realized from avoiding PMI on the first-lien mortgage at the front-end of the loan was erased in due course, after the higher rate on the HELOC was applied over enough time. It has been the states' experience that where PMI avoidance was sold to consumers as an investment strategy, when consumers were questioned about it in detail, they could not explain the relative cost and savings trade-offs inherent in the transactions, and had a very limited capacity to gauge whether the transaction had benefited or would ultimately benefit them.

4) The Rule Should Apply to Employees of the Lender

The states strongly support the Board's proposal to apply the limitations on originator compensation to employees of the lender as well as to brokers. In our experience, the observed practice of steering consumers into higher cost or more exotic loan products during the housing bubble was as fierce for loans originated in-house as for those originated through brokers. In fact, many lenders, including the largest lenders in the mortgage market, used a full compliment of in-house retail account executives and loan officers to sell the same array of highly-remunerative, high-risk loans that they sold through wholesale, correspondent, and broker channels. While the form of originator compensation varied by channel, the incentives provided to the in-house originators were similar in essence and effect.

II. Conclusion

The states strongly support the Board's proposed ban on originator compensation based on varying the terms and conditions of the loan. We hope that the Board finds our

comments useful in achieving its consumer protection goals, and we invite Board staff to contact us to discuss our recommendations further.

Sincerely,



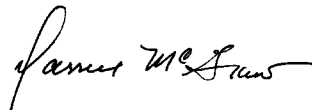
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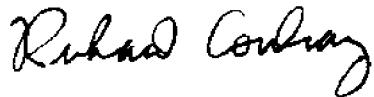
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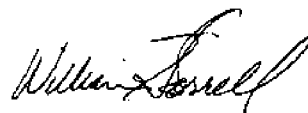
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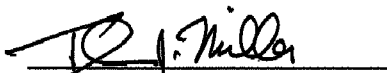
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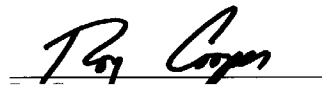
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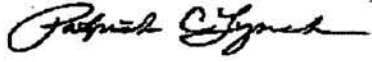
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